Legislative Audit Division

State of Montana

Report to the Legislature

December 2006

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2006

Teachers' Retirement System

Department of Administration
A component unit of the state of Montana

This report contains the financial statements and our independent auditor's report for the Teachers' Retirement System for the two fiscal years ended June 30, 2006. The report contains one recommendation concerning the actuarial soundness of the retirement system.

Direct comments/inquiries to:
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Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2007, will be issued by March 31, 2008. The Single Audit Report for the two fiscal years ended June 30, 2005, was issued on March 6, 2006. Copies of the Single Audit Report can be obtained by contacting:

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Office of Budget and Program Planning
State Capitol
Helena MT 59620
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Room 160, State Capitol
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LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
Tori Hunthausen,
Chief Deputy Legislative Auditor

Deputy Legislative Auditors:
James Gillett
Jim Pellegrini

December 2006

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the Teachers' Retirement System (system), a component unit of the state of Montana, for the two fiscal years ended June 30, 2006. This report contains one recommendation related to the actuarial soundness of the system.

We issued an unqualified opinion on the system's financial statements for the fiscal years ended June 30, 2006, and 2005. Our opinion on the system's financial statements is also contained in the Teachers' Retirement System annual report. The annual report contains additional background, statistical, and actuarial information not included in this audit report, which may be of interest to legislators or the public. Copies of the annual report can be obtained from the Teachers' Retirement System or accessed on its website. The annual report for fiscal year 2005-06 is expected to be available in December 2006.

The system's written response to the audit is included at the end of the audit report. We thank the Executive Director and his staff for their assistance and cooperation throughout the audit.

Respectfully submitted,

/s/ Scott A. Seacat

Scott A. Seacat
Legislative Auditor

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Legislative Audit Division

Financial-Compliance Audit
For the Two Fiscal Years Ended June 30, 2006

Teachers' Retirement System

Department of Administration
A component unit of the state of Montana

Members of the audit staff involved in this audit were Jeane Carstensen-Garrett, Paul J. O'Loughlin, Delsi Plummer, and Melissa Soldano.

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Appointed and Administrative Officials

Teachers' Retirement Board

Name	Location	Term Expires
Scott Dubbs, Chair	Lewistown	7/1/08
Kari Peiffer, Vice Chair	Kalispell	7/1/07
Mona Bilden	Miles City	7/1/11
Darrell Laymen	Glendive	7/1/11
Tim Ryan	Big Fork	7/1/09
James Turcotte	Helena	7/1/10

Administrative Officials

David L. Senn, Executive Director

Tammy Rau, Deputy Executive Director

Dan Gaughan, Accounting/Fiscal Manager

For additional information concerning the Montana Teachers' Retirement System, contact:

David L. Senn, Executive Director
1500 Sixth Avenue
PO Box 200139
Helena MT 59620-0139

e-mail: dsenn@mt.gov

Teachers' Retirement System

This report documents the results of our financial-compliance audit of the Teachers' Retirement System (system) for the two fiscal years ended June 30, 2006. This report contains one recommendation related to the actuarial soundness of the system. The previous audit report contained one recommendation relating to enacting legislation for funding changes to ensure the system is funded on an actuarially sound basis.

System personnel prepare the financial statements from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustment. We issued an unqualified opinion on the financial statements presented in this report, which means the reader can rely on the financial information presented.

The listing below serves as a means of summarizing the recommendation contained in the report, the system's response thereto, and a reference to the supporting comments.

Recommendation #1

We recommend legislation be enacted to provide funding to ensure the Teachers' Retirement System is funded on an actuarially sound basis, as required by the Montana Constitution. 8

System Response: Conditionally concur. See Page B-3

Introduction

General

We performed a financial-compliance audit of the Teachers' Retirement System (system) for the two fiscal years ended June 30, 2006. The objectives of our audit were to:

1. Determine the system's compliance with applicable laws and regulations.
2. Obtain an understanding of the system's control processes, and if appropriate, make recommendations for improvement in the internal and management controls of the system.
3. Determine if the financial statements prepared by system personnel fairly present the fiduciary net assets of the system as of June 30, 2006 and 2005, and the changes in fiduciary net assets for the fiscal years then ended, in conformity with generally accepted accounting principles.
4. Determine the implementation status of the prior audit recommendation.

The financial statements are prepared by system personnel from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustment. Adjustments are made to correct errors in the accounting records and to accurately present financial activity to the readers of the statements in accordance with generally accepted accounting principles (GAAP). As such, a reader should not expect these financial statements to agree in all instances to the state's primary accounting records.

This report contains one recommendation. Other areas of concern deemed not to have a significant effect on the successful operations of the system are not specifically included in the report, but have been discussed with management. In accordance with section 5-13-307, MCA, we analyzed the cost of implementing the recommendation contained in this report and determined it was significant; this is discussed in the report section.

Background

The system is a component unit of the state of Montana. A component unit is a legally separate organization for which the state of Montana is financially accountable. The system, established by state law in 1937, had more than 18,000 active members and 1,600 vested inactive members not yet receiving benefits at June 30, 2006. Approximately 10,500 retirees or their beneficiaries were receiving retirement, disability, or survivor benefits as of June 30, 2006.

A six-member board, appointed by the Governor for five-year terms, governs the system. In addition to providing oversight to system personnel, the board's responsibilities include:

- Establishing rules and regulations necessary for the proper administration and operation of the retirement system.
- Determining the eligibility of a person who is applying for membership in the system.
- Designating an actuary to provide consultation on the technical actuarial aspects of the retirement system.

The Executive Director and system personnel are responsible for the daily administration of the system. Total full-time equivalent (FTE) positions at the system as of June 2006 are 16.5.

Except as noted below, all full-time members of the public teaching profession are required by law to be members in the retirement system. By law, an eligible employee of the Montana University System (MUS), hired after July 1, 1993, must become a member of an Optional Retirement Plan (ORP), the Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), unless the employee is already a member of the Teachers' Retirement System or the Public Employees' Retirement System. The ORP is administered by the Board of Regents of Higher Education.

The 1999 Legislature passed legislation directing the Teachers' Retirement Board to implement a Guaranteed Annual Benefit Adjustment (GABA) effective in January 2000. Retirees are eligible for GABA once they have received at least 36 monthly retirement benefit payments prior to January 1 of the year in which the adjustment is to be made. GABA provides eligible retirees with a guaranteed 1.5 percent increase in retirement benefits on an annual basis. As of July 1, 2002, and as a result of the implementation of GABA, the state of Montana contributes from the General Fund 0.11 percent of the compensation for each member participating in the system. This contribution will continue until the amortization period of the unfunded liability is 10 years or less.

The system is funded with contributions from active members, their employers, and earnings on the system's investments. Active members contribute 7.15 percent of their earned compensation, while employers contribute an amount equal to 7.47 percent of the earned compensation of each member employed. The MUS also contributes an amount equal to 4.04 percent of the salaries of TIAA-CREF participants. The contributions are exempt from income tax to the employees until benefits are drawn against those contributions. The Montana Board of Investments invests the system's assets.

Prior Audit Recommendations

The financial audit report for the fiscal year ended June 30, 2005, contained one recommendation. We recommended legislation be enacted to provide funding to ensure the Teachers' Retirement System is funded on an actuarially sound basis, as required by the Montana Constitution. We determined that this recommendation has not been implemented. The system's actuarial soundness is again discussed in this report beginning on page 5.

Findings and Recommendations

System Not Actuarially Sound

The results of the July 1, 2006, actuarial valuation show the system does not meet the requirements of actuarial soundness, as required by the Montana Constitution.

Article VIII, section 15, of the Montana Constitution and Governmental Accounting Standards Board Statement No. 25, paragraph 36, requires public retirement systems be funded on an actuarially sound basis. Teachers' Retirement Board (board) policy sets a maximum amortization period of 30 years for the employer and employee contributions and investment earnings to fund current employees' future benefits, and pay the Unfunded Actuarial Accrued Liability (UAAL).

The board obtained an actuarial valuation of the system for each of the last three years. The most recent actuarial valuation was as of July 1, 2006. The actuary determined that, as of July 1, 2006, the employer contribution rate would have to be increased by 3.38 percent starting July 1, 2007, to maintain an amortization of the UAAL over a 30-year period starting July 1, 2006.

The UAAL and amortization period grew at an increasing rate between the 2000 and 2005 valuation, but decreased slightly during the 2006 valuation, as shown in Table 1. This decrease is due primarily to the one-time, $100 million infusion into the retirement fund, authorized by the 2005 Legislative Special Session. If this one-time infusion had not been made, the actuary estimated the July 1, 2006, UAAL would have been $966.9 million, rather than $863.1 million, and the contribution increase to maintain a 30-year amortization would have been 4.34 percent.

Table 1

Unfunded Actuarial Accrued Liability (UAAL) and Funding Period

Valuation Date	UAAL	Years
July 1, 2000	$ 304,400,000	15.1 years
July 1, 2002	$ 383,500,000	23.4 years
July 1, 2004	$ 757,800,000	71.3 years
July 1, 2005	$ 903,300,000	Does not amortize
July 1, 2006	$ 863,100,000	Does not amortize

Source: Compiled by the Legislative Audit Division from actuarial reports.

According to the actuary, asset gains or losses result when the return on the actuarial value of assets differs from the actuarial investment return assumption of 7.75 percent (8.0 percent before July 1, 2004). The actuarial return on assets has underperformed the assumption by about 20 percent in the last six years (combined). The root of these losses is the low market returns in the years ending June 30, 2001, and 2002. The recognition of these two years of market losses kept the actuarial return on assets below the actuarial investment return assumption until this past year. In 2006, the actuarial assets earned 8.46 percent, which is 0.71 percent above the actuarial assumption of 7.75 percent.

The Teachers' Retirement Board adopted the market value of assets to be used as the actuarial value of assets for the July 1, 2006, valuation. Therefore, there are no unrecognized asset gains or losses as of July 1, 2006. In prior valuations, the board used a smoothing asset valuation method. This method spread any market gain or loss evenly over a five year period after the gain or loss occurred.

The current actuary report states, "Although the one-time contribution of $100 million made a substantial impact on the funding of the system, the system still does not meet the requirements of actuarial soundness. To stay financially sound in the future, the system will need either (1) future gains such as asset returns well over the 7.75 percent assumption, or (2) additional contributions. Additional contributions could take the form of a one-time increase in contribution rates, a set of contribution increases graded over a number of years, or large additional contributions made outside the percent of pay contributions, such as the $100 million."

The Teachers' Retirement Board's Funding and Benefits Policy states, "Whenever the amortization period of the unfunded liabilities for two consecutive valuations are projected to exceed 30 years based on the market value of assets, or the funded ratio is less than 85 percent, and the board cannot reasonably anticipate that the amortization period would decline or the funded ratio improve without an increase in funding sources, it is the obligation of the board to recommend to the legislature that funding be increased and/or liabilities be reduced."

To comply with the maximum 30-year amortization period, the maximum UAAL would be $467.6 million, which is $395.5 million less than the current UAAL identified in Table 1. The difference of $395.5 million needs to be funded by additional contributions, contribution rate increases, or a reduction in benefits to future members.

Because the July 1, 2004, and 2005, actuarial valuations projected an amortization period of the unfunded liabilities that exceeds 30 years, the Teachers' Retirement Board sought legislation for funding changes in the 2005 Legislative Session. However, the legislation was not enacted. The board should work with the legislature to adopt and implement a funding change to ensure the system is funded on an actuarially sound basis in compliance with the Montana Constitution.

<u>Recommendation #1</u>
We recommend legislation be enacted to provide funding to ensure the Teachers' Retirement System is funded on an actuarially sound basis, as required by the Montana Constitution.

Independent Auditor’s Report

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
Tori Hunthausen,
Chief Deputy Legislative Auditor

Deputy Legislative Auditors:
James Gillett
Jim Pellegrini

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
Of the Montana State Legislature:

We have audited the accompanying Statement of Fiduciary Net Assets of the Teachers' Retirement System (system), a component unit of the state of Montana, as of June 30, 2006 and 2005, and the related Statement of Changes in Fiduciary Net Assets for each of the fiscal years then ended. These financial statements are the responsibility of the Teachers' Retirement Board. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Teachers' Retirement System as of June 30, 2006 and 2005, and the changes in fiduciary net assets for each of the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis, the Schedule of Funding Progress, and the Schedule of Contributions from the Employer and Other Contributing Entities are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements of the Teachers' Retirement System. The Supporting Schedule of Administrative Expenses is presented for purposes of additional analysis and is not a required part of the basic financial

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statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

At July 1, 2006, the system was not actuarially sound with an Unfunded Actuarial Accrued Liability (UAAL) totaling $863.1 million. In order to comply with a maximum 30-year amortization period, the current system revenue supports a maximum UAAL of $467.6 million.

Respectfully submitted,

/s/ James Gillett

James Gillett, CPA
Deputy Legislative Auditor

October 13, 2006

TEACHERS' RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis of the Montana Teachers' Retirement System's (TRS) report provides a narrative overview of the TRS's financial activities for the fiscal year ended June 30, 2006 with comparative totals for the fiscal years ended June 30, 2005 and 2004. Please read this in conjunction with the financial statements with accompanying footnotes, required supplementary information with notes, and supporting schedule.

Overview of the Financial Statements

Because of the long-term nature of a defined benefit pension plan, financial statements alone cannot provide sufficient information to properly reflect the System's ongoing plan perspective.

The financial section consists of two financial statements with footnotes, two schedules of historical trend information with footnotes, and one supporting schedule. The Statement of Fiduciary Net Assets reflects the resources available to pay benefits to retirees and beneficiaries. The Statement of Changes in Fiduciary Net Assets presents the changes that occurred in those resources for the fiscal year ended.

The Schedule of Funding Progress presents historical trend information about the actuarially funded status for the TRS plan from a long-term, ongoing perspective and the progress made in accumulating sufficient assets to pay benefits when due. The Schedule of Contributions from the Employer and Other Contributing Entities displays historical trend data of the annual required employer contributions and the actual contributions made by employers in relation to the requirement.

The Schedule of Administrative Expenses is a presentation of what comprises the administrative expense item as reported on the Statement of Changes in Fiduciary Net Assets.

Financial Highlights

- The Legislature in the December 2005 special session infused $100,000,000 into the TRS Pension fund.
- The TRS plan net assets increased by $258.7 million in 2006 and $132.3 million in 2005 representing a 10.4% and 5.6% increase respectively.
- Net investment income (fair value of investments plus investment income less investment expense) showed an increase of $36.1 million for 2006 and a decrease of $93.1 million for 2005.
- Pension benefits paid to beneficiaries and plan members increased 6.6% and 7.3% for the last two fiscal years respectively.

Financial Analysis (in millions)

	FY2006	FY2005	FY2004	2006 Percent Inc/(Dec)	2005 Percent Inc/(Dec)
Cash/Cash Equivalents	71.8	31.9	78.1	125.1	(59.2)
Investments (fair value)	2,704.4	2,540.6	2,362.5	6.4	7.5
Liabilities	52.2	107.2	109.2	(51.3)	(1.8)
Net Assets	2,745.8	2,487.1	2,354.8	10.4	5.6
Contributions	112.3	110.7	107.9	1.4	2.6
Net Investment Income	224.8	188.7	281.8	19.1	(33.0)
Benefit Payments	172.0	161.3	150.3	6.6	7.3

- The increase/decrease in cash/cash equivalents is due primarily to the change in the number of shares held in the Short Term Investment Pool.
- The significant decrease in liabilities from 2005 to 2006 is due to the decrease in Securities Lending Collateral.
- The increase in Net Investment Income for 2006 is due to the positive change in the fair market value of our investments. The decrease in net investment income for 2005 was due primarily to the decrease of $39.6 million in the net appreciation of the fair value of our investments from the previous year and a decrease of $52.7 million in our investment earnings. Also the BOI instituted a policy change in FY2005 for the Montana Private Equity Pool (MPEP) whereby realized gains/losses would remain in the fund and not be distributed to pool participants.
- The increase in benefit payments reflects an increase in the number of retirees and beneficiaries plus the 1.5% guaranteed annual benefit adjustment.

Overview of the Actuarial Funding

The TRS plan experienced an asset gain over the last year. The market assets earned 8.91% net of investment and operating expenses. The actuarial assets earned 8.46% which is 0.71% above the actuarial assumption of 7.75%. Actuarial gains or losses result when the return on the actuarial value of assets differs from the actuarial investment return assumption. The following table compares the annual returns for the past six years.

Fiscal Year	Market Return	Actuarial Return	Actuarial Return over 8.0 % Assumption (7.75% effective 7/1/04)
7/1/2000 to 6/30/2001	(5.1)%	9.2%	1.2%
7/1/2001 to 6/30/2002	(7.3)%	3.8%	(4.2)%
7/1/2002 to 6/30/2003	6.2%	1.6%	(6.4)%
7/1/2003 to 6/30/2004	13.3%	2.1%	(5.9)%
7/1/2004 to 6/30/2005	8.0%	2.7%	(5.0)%
7/1/2005 to 6/30/2006	8.9%	8.5%	0.7%

The actuarial return on assets has under performed the assumption by approximately 20% in the last six years as reflected in the above table. Therefore, to be actuarially sound in future years, the System will need to incur asset returns well over the 7.75% assumption, an increase in contribution rates, or other cash infusions. The actuarial valuation as of July 1, 2006, was completed and distributed in October 2006. Based on the results of this valuation the TRS Board will recommend options to the Legislature that are considered necessary to be actuarially sound.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF FIDUCIARY NET ASSETS
JUNE 30, 2006 AND 2005

	2006	2005
ASSETS		
Cash/Cash Equivalents-Short Term		
Investment Pool (Note B)	$ 71,802,925	$ 31,855,506
Receivables:		
Accounts Receivable	15,277,642	15,334,314
Interest Receivable	5,556,602	5,709,232
Due from Primary Government	208,840	152,802
Total Receivables	$ 21,043,084	$ 21,196,348
Investments, at fair value (Note B):		
Mortgages	$ 36,712,095	$ 43,153,151
Investment Pools	2,607,713,723	2,382,433,759
Other Investments	8,056,730	7,949,031
Securities Lending Collateral	51,930,374	107,020,752
Total Investments	$ 2,704,412,922	$ 2,540,556,693
Assets Used in Plan Operations:		
Land and Buildings	$ 193,844	$ 193,844
Less: Accumulated Depreciation	(136,118)	(132,354)
Equipment	147,087	147,087
Less: Accumulated Depreciation	(129,561)	(127,921)
Prepaid Expense	4,452	3,126
Intangible Assets, net of amortization	607,086	691,795
Total Other Assets	$ 686,790	$ 775,577
TOTAL ASSETS	$ 2,797,945,721	$ 2,594,384,124
LIABILITIES		
Accounts Payable	$ 88,974	$ 77,551
Due to Primary Government	29,446	32,212
Securities Lending Liability (Note B)	51,930,374	107,020,752
Compensated Absences (Note B)	125,880	117,069
TOTAL LIABILITIES	$ 52,174,674	$ 107,247,584
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$ 2,745,771,047	$ 2,487,136,540

The accompanying Notes to the Financial Statements are an integral part of this financial statement.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS
FISCAL YEARS ENDED JUNE 30, 2006 AND 2005

		2006		2005
ADDITIONS				
Contributions:				
Employer	$	58,268,941	$	57,150,364
Plan Member		53,292,921		52,900,262
Other		693,226		655,812
Total Contributions	$	112,255,088	$	110,706,438
Misc Income	$	3,968	$	98
Payment from State of Montana (Note C)		100,000,000		0
Investment Income:				
Net Appreciation/(Depreciation) in Fair Value of Investments	$	153,737,011	$	112,888,982
Investment Earnings		74,818,519		79,373,616
Security Lending Income (Note B)		3,918,769		2,460,271
Investment Income/(Loss)	$	232,474,299	$	194,722,869
Less: Investment Expense		3,859,788		3,701,090
Less: Security Lending Expense (Note B)		3,827,250		2,287,406
Net Investment Income/(Loss)	$	224,787,261	$	188,734,373
Total Additions	$	437,046,317	$	299,440,909
DEDUCTIONS				
Benefit Payments	$	171,956,507	$	161,247,366
Withdrawals		4,876,148		4,340,382
Administrative Expense		1,579,155		1,560,820
Total Deductions	$	178,411,810	$	167,148,568
NET INCREASE (DECREASE) IN PLAN NET ASSETS	$	258,634,507	$	132,292,341
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS BEGINNING OF YEAR		2,487,136,540		2,354,844,199
END OF YEAR	$	2,745,771,047	$	2,487,136,540

The accompanying Notes to the Financial Statements are an integral part of this financial statement.

NOTE A. DESCRIPTION OF PLAN

The Teachers' Retirement Board is the governing body of a mandatory multiple-employer cost-sharing defined benefit pension plan, which provides retirement services to persons in Montana employed as teachers or professional staff of any public elementary or secondary school, community college or unit of the university system. The system was established by the State of Montana in 1937 to provide retirement, death and disability benefits and is governed by Title 19, chapter 20, of the MCA.

At June 30, 2006, the number and type of reporting entities participating in the system were as follows:

Local School Districts	366
Community Colleges	3
University System Units	2
State Agencies	8
Total	379

At June 30, 2006, the system membership consisted of the following:

Retirees and Beneficiaries Currently Receiving Benefits	10,637
Terminated Employees Entitled to But Not Yet Receiving Benefits	10,151
Current Active Members:	
Vested	11,811
Non-vested	6,297
Total Membership	38,896

The pension plan provides retirement benefits and death and disability benefits. Employees with a minimum of 25 years of service or who have reached age 60 with 5 years of service are eligible to receive an annual retirement benefit equal to creditable service years divided by 60 times the average final compensation. Final compensation is the average of the highest three consecutive years of earned compensation. Benefits fully vest after 5 years of creditable service. Vested employees may retire at or after age 50 and receive reduced retirement benefits. A Guaranteed Annual Benefit Adjustment (GABA) of 1.5% is payable each January if the retiree has received at least 36 monthly retirement benefit payments prior to January 1 of the year in which the adjustment is to be made.

NOTE B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The TRS, a discretely presented component unit Pension Trust Fund of the State of Montana financial reporting entity, maintains its accounts on the accrual basis of accounting. Employee and employer contributions are recognized as revenues in the period in which employee services are performed and expenses are recorded when the corresponding liabilities are incurred, regardless of when payment is made.

Compensated Absences

Compensated absences represent 100 percent of accrued vacation and 25 percent of accrued sick leave for TRS personnel at June 30, 2006 and June 30, 2005.

Cash/Cash Equivalents and Investments

Cash and cash equivalents consist of funds deposited in the State Treasurer's pooled cash account and cash invested in the Short-Term Investment Pool. The Montana Board of Investments (BOI) manages the State's Unified Investment Program, which includes the TRS plan investments as required by Section 19-20-501, Montana Code Annotated. Per the Montana Constitution, Article VIII Section 13(3), investment of TRS assets shall be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use in the conduct of an enterprise of a similar character with similar aims.

Investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. The seven areas of investment include: Short-Term Investment Pool (STIP); Retirement Funds Bond Pool (RFBP); Montana Domestic Equity Pool (MDEP); Montana International Equity Pool (MTIP); Montana Private Equity Pool (MPEP), Montana Real Estate Pool (MTRP), and All Other Funds (AOF).

Securities Lending - Under the provisions of state statutes, BOI, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the BOI securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, BOI receives a fee and the custodial bank must initially receive collateral equal to 102 percent, 105% in MTIP, of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent, 105% in MTIP, of the fair value of the loaned security. BOI retains all rights and risks of ownership during the loan period.

During fiscal years 2006 and 2005, State Street Bank lent, on behalf of the BOI, certain securities held by State Street, as custodian, and received US dollar currency cash, US government securities, and irrevocable bank letters of credit. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The BOI did not impose any restrictions during fiscal years 2006 and 2005 on the amount of the loans that State Street Bank made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2006 and 2005. Moreover, there were no losses during fiscal years 2006 and 2005 resulting from a default of the borrowers or State Street Bank.

During fiscal years 2006 and 2005, the BOI and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine.

Effective June 30, 2005, the TRS implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40 – Deposit and Investment Risk Disclosures. Detailed information demonstrating the risks associated with the TRS plan investments is contained in the State of Montana BOI financial statements, and may be accessed by contacting the Board of Investments at P.O. Box 200126, Helena, MT 59620-0126. The investment risks are described in the following paragraphs.

Credit Risk - Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation.

The STIP securities and the RFBP fixed income instruments with the exception of the U.S. government securities have credit risk as measured by major credit rating services. The risk is that the issuer of a STIP or RFBP security may default in making timely principal and interest payments. The BOI policy requires that STIP securities have the highest investment grade rating in the short term category by at least one Nationally Recognized Statistical Rating Organization (NRSRO). For the RFBP fixed income investments the BOI policy requires the investments at the time of purchase to be rated an investment grade as defined by Moody's or Standard & Poors's rating services. (Please refer to the credit rating chart on the following page).

Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality.

Custodial Credit Risk - Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party.

As of June 30, 2006 and June 30, 2005, all STIP, RFBP, MDEP, and MTIP securities were registered in the nominee name for the Montana BOI and held in the possession of the BOI's custodial bank, State Street Bank. According to the STIP Investment Policy, "repurchase agreements require electronic delivery of U.S. Government Treasury collateral, priced at 102 percent market value, to the designated State of Montana Federal Reserve Bank account." All other repurchase agreements were purchased in the State of Montana BOI name. All other investments are registered in the name of the Montana BOI.

Interest Rate Risk – Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. In accordance with GASB Statement No. 40, the BOI selected the effective duration method to disclose interest rate risk.

According to GASB Statement No. 40, interest rate disclosures are not required for STIP since STIP is a 2a-7-like pool. The RFBP investment policy does not formally address interest rate risk.

Foreign Currency Risk – Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment.

The MTIP has significant investments in 11 foreign countries. Future economic and political developments in these countries could adversely affect the liquidity or value, or both, of the securities held by the funds in which MTIP is invested. At June 30, 2006 approximately 39% of the TRS MTIP portfolio is held in foreign currencies. (See chart below).

The TRS investments subject to credit and interest rate risk at June 30, 2006 and June 30, 2005 are categorized below:

Investment		Fair Value 6/30/06	Fair Value 6/30/05	Rating 6/30/06	Rating 6/30/05	Duration 6/30/06	Duration 6/30/05
STIP	$	68,736,963	27,619,404	A1+	A1+	NA	NA
RFBP		717,609,842	704,451,127	AA-	AA-	5.05	4.95

*NA (not applicable)

The securities in the RFBP have a maturity ranging from 8/1/2006 to 6/10/2046.

The investment security type MTIP is subject to foreign currency risk at June 30, 2006 as categorized below converted to value in U.S. dollars:

Currency	Carrying Amount 6/30/06	Fair Value 6/30/06	% of Total Investment
Australian Dollar	9,496,389	13,473,446	2.8
Hong Kong Dollar	7,225,413	8,929,714	1.8
Indonesian Rupiah	320,848	346,409	0.1
Japanese Yen	49,984,262	64,630,986	13.4
Malaysian Ringgit	1,163,670	1,250,176	0.3
New Taiwan Dollar	5,479,946	6,022,402	1.2
Philippine Peso	382,348	595,101	0.1
Singapore Dollar	2,644,362	3,087,046	0.6
South Korean Won	6,402,196	9,078,570	1.9
Thailand Baht	1,606,486	1,781,722	0.4
US Dollar	270,854,917	374,280,707	77.4
Total	355,560,837	483,476,279	100.0

1. STIP as per Montana Code Annotated (MCA) sections 17-6-201, 202 and 204, requires investments by state agencies of available funds. The STIP unit value is fixed at $1 for both participant buys and sells. The STIP portfolio may include asset-backed securities, commercial paper, corporate and U.S. government direct-backed U.S. government indirect-backed securities, repurchase agreements, and variable-rate (floating-rate) instruments to provide diversification and a competitive total rate of return.

According to the Governmental Accounting Standards Board (GASB) Statement No. 31, Accounting and Financial Reporting for Certain Investments and External Investment Pools, STIP is considered an external investment pool. An external investment pool is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool.

2. The RFBP portfolio includes securities classified as corporate, foreign government bonds, U.S. government direct-backed, U.S. government indirect-backed, and cash equivalents. U.S. government direct-backed securities include direct obligations of the U.S. Treasury and obligations explicitly guaranteed by the U.S. government. U.S. government indirect-backed obligations include U.S. government agency and mortgage-backed securities. U.S. government mortgage-backed securities reflect participation in a pool of residential mortgages. Unit values are calculated weekly and at month end based on portfolio pricing. Unit value at June 30, 2006 and June 30, 2005 was $99.81 per unit and $105.31 per unit respectively.

As of June 30, 2006 and June 30, 2005, Northwest Airlines Inc. presented a higher credit risk to the BOI. The RFBP held a $5,745,000 par 4.64% Northwest Airlines Inc. real estate backed bond maturing July 7, 2010. This bond, with a June 30, 2006 and 2005 book value of $5,745,000 is secured by Northwest Airlines Inc.'s corporate headquarters building and land.

As of June 30, 2005 the RFBP held a $9,930,036 par 6.81% Northwest Airlines Inc. bond maturing February 1, 2020 and a $7,802,614 par 7.935% Northwest Airlines Inc. MBIA Insurance Corp. insured bond maturing April 1, 2019. The combined book value of these two securities was $17,244,339 as of June 30, 2005. On September 14, 2005, the company filed for Chapter 11 bankruptcy protection. Due to this action, the BOI stopped the interest income accruals for the 6.81% bond maturing February 1, 2020 after the August 2005 pay date. This issue was sold on September 20, 2005 generating a loss of $642,183. The sale included accrued interest from August 1, 2005 to September 20, 2005. Since the 7.935% bond maturing April 1, 2019 is insured by MBIA Insurance Corp. to support the payment of any interest due and outstanding principal balance, the BOI did not stop the interest income accrual or reduce book value. On January 11, 2006 Northwest Airlines Inc. called the 7.935% bond maturing April 1, 2019 at par and included accrued interest from October 1, 2005 to January 11, 2006. The BOI recorded a gain of $132,710 on this transaction.

As of June 30, 2006 and June 30, 2005, Burlington Industries, Inc. presented a legal and higher credit risk to the BOI. The BOI owns a Burlington Industries, Inc., $6 million par, 7.25% bond maturing September 15, 2005. In September 2000, the company announced a reduction of stockholders equity. Due to an increasing senior bank line and declining credit trend, the bond ratings for this issue were downgraded, in May 2001, by the Moody's and Standard & Poor's rating agencies. During fiscal year 2001, the book value of Burlington Industries Inc. was reduced from the August 31, 2000 book value of $5,609,640 to $2,400,000. Due to the company's filing for Chapter 11 bankruptcy protection on November 11, 2001, the book value was reduced to $1,200,000. In October 2003, Burlington Industries, Inc. received court approval to sell its assets. Under the company's recovery plan, the BOI received $1,454,961 in August 2004 for its unsecured claim. This transaction reduced the book value to $0 and generated a gain of $254,961. In February 2005 and May 2005, the BOI received an additional $208,771 and $194,247, respectively, for its unsecured claim. In May 2006, the BOI received an additional payment of $158,278. The BOI is expected to receive the final distribution in September 2006.

As of June 30, 2005, Delta Airlines Corp. presented a higher credit risk to the BOI. The RFBP holds $3 million par 10.0% Delta Airlines Corp. bond maturing June 5, 2013, a $1.971 million par 10.0% Delta Airlines Corp. bond maturing June 5, 2011 and a $6 million par 10.14% Delta Airlines Corp. bond maturing August 14, 2012. Due to a weak credit outlook and potential bankruptcy, the BOI stopped the interest income accruals after the December 2004 and February 2005 pay dates. Although the interest accruals were stopped, the BOI received the interest due in June 2005 and August 2005. The combined book value of these securities was $10,949,050 as of June 30, 2005. Due to the company's filing for Chapter 11 bankruptcy protection on September 14, 2005, the book values were reduced to $1.5 million, $985,500 and $3 million, respectively. On March 20, 2006, the BOI sold these securities and recorded a combined gain of $892,680.

DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The BOI received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, $5 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of $94.669 plus accrued interest. Deutsche Bank Securities seeks damages of $538,632 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The BOI tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of $113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the BOI received $5,683,075 in principal and interest plus $150,000 as a consent fee.

On December 11, 2003, the Supreme Court of the State of New York, New York County, entered an order dismissing Deutsche Bank's complaint on jurisdictional grounds. Deutsche Bank appealed that decision to the Appellate Division, which on June 14, 2005 reversed the Supreme Court and entered an order determining the BOI to be liable and remanding the matter back to the Supreme Court for a determination of damages. The BOI appealed that decision to the New York Court of Appeals, which on June 6, 2006 affirmed the Appellate

Divison's decision. The BOI has since petitioned for certiorari to the United States Supreme Court on certain jurisdictional issues. At the same time, discovery is proceeding in the New York Supreme Court to determine damages.

3. The MDEP portfolio may include common stock, equity index, preferred stock, convertible equity securities, American Depositary Receipts and equity derivatives. Unit value at June 30, 2006 and June 30, 2005 was $138.01 per unit and $128.67 per unit respectively.

OWENS-CORNING COMPLAINT

On October 11, 2002, the BOI received a summons and complaint regarding the bankruptcy of Owens-Corning. The company seeks a determination that the dividend payments paid from October 1996 through July 2000 represent "fraudulent transfers under Chapter 11 Bankruptcy provisions and applicable state law, and are, therefore, voidable". The complaint states the BOI was the "recipient of dividends in the amount of $357,099 for the relevant period". The BOI has prepared a response to the complaint. As of September 22, 2006 this matter is still pending.

4. The MTIP portfolio includes equity investments in six funds that invest in securities of foreign-based corporations listed on legal and recognized foreign exchanges as well as domestic exchanges. Security types may include ordinary common shares, preferred shares, convertible securities, American Depositary Receipts (ADR's), Global Depositary Receipts (GDR's), and other global securities, as appropriate. Unit values are calculated weekly and once a month at the close of the last business day of the month, based upon the fair value of the MTIP equity holdings, other assets and liabilities. Unit value at June 30, 2006 and June 30, 2005 was $151.74 per unit and $121.64 per unit respectively.

5. The MPEP portfolio includes venture capital, leveraged buyout, mezzanine, distressed debt, special situation and secondary investments. Private equity investments are long-term, by design, and very illiquid. Due to the complexity and specialization of private equity investment, the BOI contracts with external private equity managers to invest in venture capital, leveraged buyout and other private equity investments.

Unit value at June 30, 2006 and June 30, 2005 was $135.55 and $116.06 per unit respectively. The unit value is calculated at month end.

6. The MTRP was approved by the BOI on April 26, 2006, to permit the state's retirement systems to participate in a diversified real estate portfolio. Effective June 1, 2006, the nine retirement funds sold $30,035,000 of their STIP shares to fund the new Montana Real Estate Pool. The MTRP will invest with external real estate managers in both open-end and closed-end pooled funds. Each pension fund participant was issued units in the new pool at an initial unit value of $100. Unit values are calculated on the close of the last business day of the month, and based on the portfolio fair value. The unit value at June 30, 2006 was $100.00.

7. The AOF investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle" and applicable investment restrictions of the participants. The AOF portfolio includes securities classified as corporate, U.S. government direct-backed, U.S. government indirect-backed, equity index, real estate, mortgages and loans.

In June 2005, the BOI received notice that Positive Systems, Inc. has "ceased business operations". This borrower, funded by the Montana Science and Technology Alliance (MSTA), received $200,000 and $350,000 in May 1994 and March 1998, respectively. As of June 30, 2006 and 2005, Positive Systems, Inc. had an outstanding loan balance of $546,074. In July 2006, the BOI received confirmation that Positive Systems, Inc. has "indeed ceased all business operation". This loan balance of $546,074 was written off in September 2006. With the exception of this loan, there were no other uncollectible account balances for Montana mortgages and loans receivable as of June 30, 2006 and 2005. In February 2005, the BOI charged off $147, 156 in principal for Safe ShopTools, Inc. The MSTA funded a total of $162,500 to Safe ShopTools, Inc. in February 1997 and June 1999.

Real Estate Investments

100 North Park Building - In January 1996, the BOI, on behalf of the Public Employees' and Teachers' Retirement funds, purchased the 100 North Park Avenue Building in Helena, Montana as a real estate investment. Acquired for a cost of $4,864,326, the building carries a fair value of $6,141,593 as of June 30, 2006. During fiscal year 2006, building improvements for tenant remodeling, heating/cooling, and leasing fees totaling $64,607 were added to the cost of the building. Building improvements and leasing fees totaling $151,567 were included in the cost of the building in fiscal year 2005. The three-story building provides office space for approximately eight to ten tenants.

2401 Colonial Drive Building - In August 1997, the BOI authorized the construction of an office building, as a real estate investment owned equally by the Public Employees' and Teachers' Retirement funds. Construction costs, including interest capitalization, totaled $6,481,741 as of June 30, 2000. In fiscal year 2006, heating/cooling system improvements and leasing fees of $93,257 were added to the building cost. For fiscal year 2005, $48,838 was expended on parking lot resurfacing and heating/cooling system improvements. The three-story building, providing office space for three tenants, was occupied in November 1999. As of June 30, 2006, the building carries a cost and fair value of $7,183,851 and $7,676,250, respectively.

2273 Boot Hill Court Building - In August 1999, the BOI authorized the purchase of a new office building in Bozeman, Montana. Upon construction completion, the Public Employees' and Teachers' Retirement funds purchased the building, in March 2004, as a real estate investment with equal ownership, for $2,051,032. In fiscal year 2006, there were no improvements made to this building. In fiscal year 2005, telecommunication system payments were added to the building cost of $10,238. The building, located on state school trust land, is occupied by four state agencies. As of June 30, 2006, the building carries a fair value of $2,082,014.

DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The BOI received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, $2 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of $94.669 plus accrued interest. Deutsche Bank Securities seeks damages of $215,453 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The BOI tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of $113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the BOI received $2,273,230 in principal and interest plus $60,000 as a consent fee.

On December 11, 2003, the Supreme Court of the State of New York, New York County, entered an order dismissing Deutsche Bank's complaint on jurisdictional grounds. Deutsche Bank appealed that decision to the Appellate Division, which on June 14, 2005 reversed the Supreme Court and entered an order determining the BOI to be liable and remanding the matter back to the Supreme Court for a determination of damages. The BOI appealed that decision to the New York Court of Appeals, which on June 6, 2006 affirmed the Appellate Divison's decision. The BOI has since petitioned for certiorari to the United States Supreme Court on certain jurisdictional issues. At the same time, discovery is proceeding in the New York Supreme Court to determine damages.

NOTE C. CONTRIBUTIONS

The TRS funding policy provides for monthly employee and employer contributions at rates specified by state law. Plan members are currently required to contribute 7.15% of their earned compensation and employers contribute 7.47% of earned compensation. The State's General Fund contributes an additional 0.11% of earned compensation. Each employer in the Montana university system shall contribute to the TRS a supplemental employer contribution currently at a rate of 4.04% of the total compensation of employees participating in the Optional Retirement Program (ORP). An actuary determines the actuarial implications of the funding requirement in biennial actuarial valuations. The actuarial method used to determine the implications of the statutory funding level is the entry age actuarial cost method, with both normal cost and amortization of the accrued liability determined as a level percentage of payroll. The actuarial valuation prepared as of July 1, 2006, the most recent valuation date, indicates the statutory rate is insufficient to fund the normal cost and to amortize the unfunded accrued liability under the entry age actuarial cost method over 30 years. The unfunded actuarial accrued liability is included in the Schedule of Funding Progress.

The Montana State Legislature during the December 2005 special session infused $100 million from the State's General Fund into the TRS pension fund to help address the unfunded actuarial accrued liability of the system.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
REQUIRRED SUPPLEMENTARY INFORMATION

Schedule of Funding Progress
(All dollar amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liabilities (AAL)[1]	Present Value of Future University Supplemental Contributions	Unfunded Actuarial Accrued Liabilities (UAAL)[2]	Funded Ratio[3]	Covered Payroll[4]	UAAL as a Percentage of Covered Payroll
July 1, 1998[5]	$ 1,809.0	$ 2,123.3	$ 90.6	$ 223.7	89.0%	$ 529.8	42.2%
July 1, 1998[6]	1,809.0	2,342.7	90.6	443.1	80.3	529.8	83.6
July 1, 2000[7]	2,247.5	2,648.3	96.4	304.4	88.1	537.5	56.6
July 1, 2000[8]	2,247.5	2,652.0	96.4	308.1	87.9	537.5	57.3
July 1, 2002	2,484.8	2,980.1	111.8	383.5	86.6	563.2	68.1
July 1, 2004	2,485.7	3,359.2	115.7	757.8	76.6	600.7	126.2
July 1, 2005	2,497.5	3,527.0	126.2	903.3	73.4	612.6	147.5
July 1, 2006	2,745.8	3,733.6	124.7	863.1	76.1	636.0	135.7

(1) Actuarial present value of benefits less actuarial present value of future normal costs based on entry age actuarial cost method.
(2) Actuarial accrued liabilities less actuarial value of assets and present value of future university supplemental contributions.
(3) Funded Ratio is the ratio of the actuarial value of assets over the actuarial accrued liabilities less the present value of future university supplemental contributions.
(4) Covered Payroll includes compensation paid to all active employees on which contributions are calculated.
(5) Results of July 1, 1998 Actuarial Valuation.
(6) July 1, 1998 results adjusted for 1.5% GABA and $500 minimum benefit for legislation which passed in Spring 1999 and the new salary scale adopted in November 1998.
(7) Results of July 1, 2000 Actuarial Valuation.
(8) July 1, 2000 results adjusted for $600 minimum benefit for legislation which passed in Spring 2001.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
REQUIRED SUPPLEMENTARY INFORMATION

Schedule of Contributions from the Employer and Other Contributing Entities
(All dollar amounts in thousands)

Fiscal Year Ending	Covered Employee Payroll[1]	Actual Employer Contributions[2]	Actual Employer Contribution %[2]	Annual Required Contribution (ARC) %[3]	Percentage of ARC Contributed[4]
6/30/1998	529,795	44,476	7.47	7.47	100
6/30/1999	543,071	44,987	7.47	7.47	100
6/30/2000	537,507	48,376	7.58	7.58	100
6/30/2001	567,861	51,524	7.58	7.58	100
6/30/2002	563,163	51,519	7.58	7.58	100
6/30/2003	597,131	53,277	7.58	7.58	100
6/30/2004	600,728	55,774	7.58	7.58	100
6/30/2005	612,622	57,150	7.58	7.58	100
6/30/2006	635,997	158,962	7.58	10.45	223

(1) *Computed as the dollar amount of the actual employer contribution made as a percentage of payroll (less ORP and term pay contributions) divided by the contribution rate expressed as a percentage of payroll.*

(2) *The actual and required employer contributions are expressed as a percentage of payroll. Contributions for termination pay of $5,247,505 and supplemental university contributions of $5,512,447 are included in the $158,962,167 actual employer dollar contribution, but are not made as a set percentage of payroll, and do not help to satisfy the ARC. Therefore, they are not included in the 7.58% employer contribution shown in this exhibit, or the calculation of the percentage of ARC contributed. The $100 million one time contribution made by the State at January 1, 2006 is included in the 2006 employer dollar contribution, and the calculation of the percentage of ARC contributed, but is not included in the 7.58% employer contribution shown in this exhibit.*

(3) *The State makes employer contributions as a percentage of actual payroll. Thus, as long as the percentage equals the percentage required by the most recent actuarial valuation, the dollar amount of the ARC is equal to the actual dollar amount of the required employer contributions. The 2006 ARC was determined in the July 1, 2004 valuation as the amount needed starting July 1, 2005 to maintain a 30 year amortization period.*

(4) *This is the ARC expressed as a percentage of the product of the ARC percent and the Covered Employee Payroll.*

Actuarial Cost Method

The actuarial valuation was prepared using the entry age actuarial cost method. Under this method, the actuarial present value of the projected benefits of each individual included in the valuation is allocated as a level percentage of the individual's projected compensation between entry age and assumed exit. The portion of this actuarial present value allocated to a valuation year is called the normal cost. The normal cost was first calculated for each individual member. The normal cost rate is defined to equal the total of the individual normal costs, divided by the total pay rate.

The portion of this actuarial present value not provided for at a valuation date by the sum of (a) the actuarial value of the assets and (b) the actuarial present value of future normal costs is called the unfunded actuarial accrued liability. The unfunded actuarial accrued liability is amortized as a level percentage of the projected salaries of present and future members of the System.

The ultimate cost of any pension program over time equals the benefits paid and expenses incurred while administering the program. The source of revenue used to pay for this cost is equal to the contribution from employers and employees to fund the program, plus investment return earned on contributions made through pre-funding the benefit payments.

Valuation of Assets - Actuarial Basis

Market value is used as the actuarial basis for the valuation of assets. (Adopted effective July 1, 2006)

Investment Earnings

The annual rate of investment earnings of the assets of the System is assumed to be 7.75% per year, compounded annually. (Adopted effective July 1, 2004)

Guaranteed Annual Benefit Adjustment Increases

On January 1 of each year, the retirement allowance payable must be increased by 1.5% if the retiree's most recent retirement effective date is at least 36 months prior to January 1 of the year in which the adjustment is to be made.

Future Salaries

The rates of annual salary increases assumed for the purpose of the valuation include an assumed 4.5% annual rate of increase in the general wage level of the membership plus a variable merit and longevity rate from 0% to 4.51%. The merit and longevity increases for the Montana University System (MUS) members did not show a pattern of increasing or decreasing with service at the time of our most recent study. Therefore, the MUS members have a flat 1% merit and longevity assumption. The general wage increase assumption was adopted July 1, 2004 and the merit and longevity scales were adopted July 1, 2002.

MUS members are assumed to have a 0.63% higher average final compensation to account for the larger than average annual compensation increases observed in the years immediately preceding retirement.

Amortization Period

The current employer contribution rate of 7.47% and the State General Fund contribution of 0.11% of members' salaries are insufficient to meet the actuarial cost of the System accruing at the valuation date and to amortize the unfunded actuarial liability over an open period of 30 years as of July 1, 2006.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
SUPPORTING SCHEDULE
FISCAL YEARS ENDED JUNE 30, 2006 AND 2005

ADMINISTRATIVE EXPENSES

Expenses for the administration of the plan, excluding compensated absences, depreciation and amortization, are budgeted and approved by the TRS Board. The administrative costs of the TRS are financed through realized investment income. The expenses, less amortization of intangible assets, may not exceed 1.5% of retirement benefits paid. Administrative expenses for the fiscal years ended June 30, 2006 and 2005, are outlined below:

	2006	2005
Budgeted Expenses:		
Personnel Services:		
Salaries	$ 628,364	$ 584,815
Other Compensation	2,450	1,900
Employee Benefits	186,284	174,390
Total Personal Services	$ 817,098	$ 761,105
Operating Expenses:		
Contracted Services:		
Personnel Management	$ 6,146	$ 3,263
Actuarial Services	133,216	150,859
Legal Services	3,076	4,306
Medical Evaluations	205	1,180
Audit Services	17,771	5,447
Information Technology Srvcs	117,058	177,735
Other Contracted Services	150,158	138,432
Supplies & Material	32,806	24,840
Communications	39,466	38,003
Travel	12,375	12,770
Rent	44,915	42,437
Repair & Maintenance	56,207	53,078
Other Expenses	49,734	48,810
Total Operating Expenses	$ 663,133	$ 701,160
Non-Budgeted Expenses:		
Compensated Absences	$ 8,811	$ 8,442
Depreciation	5,403	5,403
Amortization of Intangible Assets	84,710	84,710
Total Non-Budgeted	$ 98,924	$ 98,555
Total Administrative Expense	**$ 1,579,155**	**$ 1,560,820**

System's Response

TEACHERS' RETIREMENT SYSTEM

1500 E. SIXTH AVENUE
PO BOX 200139
HELENA, MONTANA 59620-0139
(406) 444-3134
BRIAN SCHWEITZER, GOVERNOR

STATE OF MONTANA

November 30, 2007

RECEIVED
NOV 3 0 2006
LEGISLATIVE AUDIT DIV.

Scott A Seacat
Legislative Auditor
Room 160 State Capitol
PO Box 201705
Helena MT 59620-1705

Dear Mr. Seacat:

Thank you for the opportunity to reply to the audit report for the Teachers' Retirement System. Once again, we are pleased with the unqualified opinion on the financial statements for the two fiscal years ending June 30, 2006.

The report includes one recommendation that legislation be enacted to provide funding to ensure the Teachers' Retirement System is funded on an actuarially-sound basis, as required by the Montana Constitution. The Board conditionally concurs with the recommendation.

While the Teachers' Retirement Board cannot enact legislation, in anticipation of the 2007 Session, legislation has been drafted and included in the Governor's budget that will ensure the Teachers' Retirement System is funded on an actuarially sound basis.

Sincerely,

David L. Senn
Executive Director